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In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 644

VALENTINE-CLARK CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 15–25) is reported at 46 B. T. A. 821. The opinion of the Circuit Court of Appeals (R. 87–93) is reported at 137 F. 2d 481.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on August 3, 1943 (R. 93–94), and petition for rehearing was denied August 31, 1943 (R. 101). An extension of time to January 29, 1944, was secured for filing a petition for a writ of certiorari (R. 103), and a petition was

filed on January 28, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the petitioner was prohibited by its written contract from paying dividends in any form and is thereby entitled to credits in the taxable years under Section 26 (c) (1) of the Revenue Act of 1936.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are set forth in the Appendix, *infra*, pp. 14–20.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 16–22) may be summarized as follows:

The petitioner, a Washington corporation having its principal office in St. Paul, Minnesota, is engaged in the business of treating cedar poles and other forest products. It keeps its books and files its income tax return on the accrual basis of accounting (R. 16).

During 1935 the petitioner's authorized capital stock consisted of 1,000 shares of common stock of a par value of $100, all of which was beneficially owned by Lillian S. Clark or her daughter, Grace C. Pyle (R. 16–17).

From 1933 until 1935, petitioner's business was operated under a line of credit established with

the Northwestern National Bank & Trust Company of Minneapolis, hereinafter referred to as the Northwestern Bank. Although its business had continued to improve, the petitioner in 1935 found itself without sufficient funds to purchase materials in such quantities as were necessary to handle its business. This condition was due to the fact that more capital was needed to take care of the expanding sales and the further fact that in each year all net earnings were being taken out of the business, one-half by M. H. Sperry, the general manager, as compensation under his contract of employment and one-half by Mrs. Clark and Mrs. Pyle in the form of dividends. In 1935 Clarence E. Hill, vice president of the Northwestern Bank, advised petitioner that so long as that state of affairs continued the bank would not allow any further extension of credit, and, furthermore, would insist that existing bank loans be paid, and that the only conditions under which the bank would make any further loans were that annual withdrawals for salaries to officers and for dividends to shareholders be limited to a total of $12,000, and, further, that Sperry or whoever was responsible for the active direction of the petitioner's affairs would be required to have a personal investment at stake in the enterprise (R. 17).

After holding several conferences with an attorney and with officers of the bank, Mrs. Clark and Sperry advised the bank that its terms for further extension of credit would be met (R. 17).

Pursuant thereto, on November 18, 1935, petitioner as first party, Lillian S. Clark as second party, and M. H. Sperry as third party executed a written agreement, the material portions of which are as follows (R. 18–19):

> 1. Second party agrees that so long as such line of credit is made available to first party by said bank and/or so long as any indebtedness of first party exists in favor of said bank on account of loans made under said line of credit, she will not make or permit withdrawals from the corporate funds to herself or any members of her family by way of salaries, dividends, loans or advances in excess of $6,000.00 per year (which last mentioned amount, however, may be paid to her and/or any member of her family as she may designate in monthly instalments). This agreement shall become effective as of January 1st, 1936, and between that date and the date of this memorandum any such withdrawals by second party and/or any member of her family shall not exceed the sum of $700.00 per month for the months of November and December, 1935.
>
> 2. Third party agrees that so long as such line of credit is made available to first party by said bank, and/or so long as any indebtedness of first party exists in favor of said bank on account of loans made under said line of credit, he will not make withdrawals or accept payment from said cor-

poration on account of compensation other than as follows:

(a) With regard to his salary now fixed at $7500.00 per year, he will not draw out in cash more than $6000.00 per year, which may be paid to him in monthly instalments. The balance of said fixed salary shall remain as an obligation of first party to him and shall be evidenced either as a credit to him on the corporate books or by a corporate note to be given to him.

(b) With regard to his right to additional compensation to the extent of one-half of the annual net earnings of first party, he shall not withdraw any such amounts to which he may be or become entitled but the same shall remain as a corporate obligation to him to be evidenced either by credits to him on the corporate books or by a corporate note or notes to be given to him.

This agreement shall become effective as of January 1st, 1936; and between that date and the date of this memorandum third party shall be entitled to withdraw the full unpaid instalments of his said fixed salary for 1935, but shall not withdraw any amounts to which he may be entitled as his share of the corporate earnings for 1935.

To conform further with the condition that Sperry acquire a personal investment in the enterprise, Sperry, Mrs. Clark, and Mrs. Pyle, on November 23, 1935, signed another contract which provided, among other things, that Mrs. Clark

and Mrs. Pyle would cause petitioner's capital structure to be revised on or before January 1, 1936, so as to authorize 1,500 shares of preferred stock of the par value of $100 each and so as to reduce and authorize common stock to 200 shares without par value; and that Sperry's 1933 contract of employment should be terminated and he would be given a new contract running seven years beginning January 1, 1936, and providing for a minimum annual salary of $6,000 (R. 20).

The changes thus provided for in petitioner's capital structure were completed not later than December 30, 1935, and the new stock was issued on that date. Of the 1,500 shares of preferred stock, 1,312½ shares were issued to Mrs. Clark and the remaining 187½ shares to Mrs. Pyle, and they were the owners thereof during the taxable years. Of the 200 shares of common stock, 85 shares were issued to Mrs. Clark, 15 to Mrs. Pyle, and 100 to Sperry, and the common stock was so held until August 20, 1936. From that date until June 30, 1937, the said 200 shares were held as follows: 20 shares by Mrs. Clark, 30 shares by Mrs. Pyle, 50 shares by Mrs. Clark and Mrs. Pyle as joint tenants, and 100 shares by Sperry (R. 21).

After petitioner delivered to the bank copies of the two contracts above described, the bank opened a line of credit for taxpayer. It did so in reliance upon the terms and conditions set

forth in those contracts. Between January 1, 1936, and June 30, 1937, the line of credit was continuously indebted to the bank. At no time during that period was petitioner able to make payment in full of its indebtedness to the bank without adversely affecting its business and competitive position (R. 21).

In November, 1936, petitioner requested the Northwestern Bank for permission to pay dividends and salaries in excess of the limits specified in the contract of November 18, 1935. Such permission was denied as to dividends, but the bank gave its approval to the payment of a $2,500 bonus to Sperry and such bonus was paid (R. 21).

In June, 1937, petitioner requested the bank, first orally and then by letter, for permission to pay dividends in excess of the limits prescribed in the contract of November 18, 1935. The bank, first orally and then by letter, gave petitioner permission to pay a dividend on its common stock of $5,000 in cash and $15,000 in petitioner's notes, on condition that such notes be subordinate to all bank loans and on the further condition that the notes mature not earlier than two years from date. A dividend was declared and paid as thus permitted (R. 22).

Petitioner's balance sheets dated December 31, 1936, and June 30, 1937, show earned surplus in the respective amounts of $25,905.33 and $28,966.36 (R. 22).

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Upon the basis of the foregoing facts the Board held that the contract of November 18, 1935, did not prohibit the payment of taxable stock dividends, and that, in computing the surtax on undistributed profits for 1936 and the period January 1 to June 30, 1937, the Commissioner correctly disallowed to the taxpayer a credit under the provisions of Section 26 (c) (1) of the Revenue Act of 1936 (R. 24–25). The Circuit Court of Appeals affirmed the Board's decision (R. 93–94) and denied the petition for rehearing (R. 101).

ARGUMENT

In computing the surtax imposed upon a corporation under the Revenue Act of 1936, a credit is allowed by Section 26 (c) (1) (Appendix, *infra*) to the extent of—

> An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends.

This case presents the question of whether the petitioner is entitled to such a credit by reason of its contract of November 18, 1935, in which its president and principal stockholder agreed that so long as a line of credit was made available to the petitioner by a certain bank, she would not make

or permit withdrawals from the corporate funds to herself or any members of her family by way "of salaries, dividends, loans or advances in excess of $6000.00 per year" (R. 18). The Board of Tax Appeals held that, since this contract did not prohibit the payment of stock dividends, the petitioner was not entitled to the credit (R. 24). The court below affirmed the Board's decision (R. 87–93).

The decision of the court below is in accord with *United States* v. *Dakota Tractor & Equipment Co.,* 125 F. 2d 20 (C. C. A. 8th), in which this Court denied a petition for a writ of certiorari, 316 U. S. 671; and *Commissioner* v. *Columbia River P. M.,* 127 F. 2d 558 (C. C. A. 9th). In those cases Section 26 (c) (1) was construed as covering dividends in any form whatsoever and not as applying merely to dividends payable in cash. See also *Commissioner* v. *Oswego Falls Corp.,* 137 F. 2d 173 (C. C. A. 2d). The administrative construction of the statute is to the same effect. Article 26–2 (b) of Regulations 94 (Appendix, *infra*).

Such construction of the statute is further supported by decisions holding that Section 26 (c) (1) grants a special credit in the nature of a deduction and must be strictly construed against the taxpayer who has the burden of showing that it comes within the exact statutory terms. *Helvering* v. *Ohio Leather Co.,* 317 U. S. 102; *Helvering* v. *Northwest Steel Mills,* 311 U. S. 46.

Notwithstanding these decisions, the petitioner argues that Section 26 (c) (1) should not be construed as applying to stock dividends or dividends of any kind but those payable in cash. The statute, however, is not so limited in terms and the petitioner cites no cases which support such a construction. Instead, it relies on a statement made on the Senate floor as to a change in the provision there. The statement, however, is quite inconclusive on the question,[1] and a construction of the word "dividends" to include stock dividends would seem to be in accord with the legislative purpose in enacting the undistributed profits tax law. See *Commissioner* v. *Columbia River P. M., supra,* p. 560. Section 27 of the same Act (Appendix, *infra*) is *in pari materia,* Section 27 being designed to grant credit for

[1] Section 15 (a) of H. R. 12395, as introduced in the Senate, provided: "If under a written contract executed by the corporation prior to March 3, 1936, there is no form in which dividends equal to the adjusted net income for the taxable year may be paid during the taxable year without violating a provision of such contract expressly dealing with the payment of dividends," the tax should be computed in a certain manner provided it did not increase the tax which would otherwise be payable. The statement of Senator La Follette that the Senate revision (which became Section 26 (c) (1) of the Revenue Act of 1936) was a more liberal provision may well be explained by the fact that the critical date for entering into contracts restricting dividends was extended to May 1, 1936. The significance of the earlier date was that it was the date on which the President sent a message proposing that a tax be levied on the undistributed profits of corporations. H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 1–3.

dividends actually paid and Section 26 (c) (1) being designed to give a credit to corporations which could not pay dividends because of a contract. Inasmuch as Section 27 makes specific provision for dividends payable in cash, in kind, in obligations of the corporation and for taxable and nontaxable stock dividends, Congress must have intended that Section 26 (c) (1), as a complementary section, should have the same scope, particularly as there is no limiting phrase in that section.

While petitioner concedes that there is no conflict in the cases, it indicates that there has been considerable uncertainty in Board decisions on the issue here and that clarification is needed. Such an uncertainity would not constitute a basis for certiorari but in any event none of the cases to which the petitioner refers supports the interpretation of Section 26 (c) (1) which it contends for here. Instead, the Board decisions, as well as other cases in point, agree that the term "dividends" should be defined as including stock dividends.[2] Consequently, under any of the cases,

[2] The only difference of opinion has been over the question of whether stock dividends which are nontaxable in the hands of stockholders are covered by Section 26 (c) (1) under the term "dividends" as well as taxable stock dividends. In some earlier cases, the Board held that the credit should be denied only where taxable stock dividends could be paid. See *Helms Bakeries* v. *Commissioner*, 46 B. T. A. 308; *Paraport Theatre Leasing Corp.* v. *Commissioner*, 44 B. T. A. 108. While there have been some inconsistencies, more recently the Board has

the credit should be denied here inasmuch as the contract dealt only with cash dividends, and stock dividends could have been distributed without violating the provision of its written contract.

Furthermore, if facts outside the contract are to be considered, the evidence here is ample to support the Board's finding that there was no intention to restrict the payment of dividends in stock, taxable or otherwise (R. 24.) In fact, it was contemplated when the contract was made that new stock would be issued under a plan to give petitioner's manager a proprietary interest in the company, and such plan was carried out by issuing both common and preferred stock. During the taxable years, the petitioner had net income and earned surplus which could have been transferred to its capital account if stock dividends had been issued (R. 11, 12, 53, 55). Also under the law of Washington (Appendix, *infra*), petitioner could have easily changed its capital structure again, if necessary, in order to declare stock dividends. And, having two classes of stock during the taxable years, it could have

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been construing Section 26 (c) (1) more strictly. Thus while it looked at first beyond the contract to determine whether the taxpayer could pay a taxable stock dividend, it now holds that the right to the credit depends entirely on the contract and if there is nothing therein to prohibit a stock dividend, it has denied the credit without consideration of other facts. *Oregon Pulp & Paper Co.* v. *Commissioner*, 47 B. T. A. 772. *Kaufmann Department Stores Securities Corp.* v. *Commissioner*, 2 T. C. 656.

issued stock dividends which would have been taxable in the hands of its stockholders, if taxability of a dividend is a prerequisite to prevent the granting of a credit under Section 26 (c) (1), but see *United States* v. *Dakota Tractor & Equipment Co., supra,* indicating otherwise. However, we submit that the provisions of the contract should be decisive of the issue and the contract here did not refer to or prohibit the distribution of stock dividends.

CONCLUSION

The decision of the court below is correct, and the petition for a writ of certiorari should be denied.

Respectfully submitted.

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